

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company	)	
	)	
	)	Docket No. 02-0690
Proposed general increase in	)	
water and sewer rates.	)	

DIRECT TESTIMONY OF  
  
LAFAYETTE K. MORGAN, JR.

ON BEHALF OF THE  
  
CITIZENS UTILITY BOARD

**\*\*PUBLIC VERSION\*\***

February 5, 2003

## TABLE OF CONTENTS

	<u>Page</u>
Introduction and Summary .....	1
Cash Working Capital.....	4
Reverse Osmosis Expense.....	5
Amortization of Prior Period Security Costs.....	6
Chemicals Expense .....	7
Fuel and Purchased Power Expense .....	8
Waste Disposal Expenses.....	9
Management Fees .....	10
Customer Call Center Expense.....	11
Group Insurance.....	11
Insurance Other Than Group .....	12
Customer Expense .....	14
Ongoing Security Costs.....	15
Maintenance Expense.....	15
Payroll Expense .....	16
Interest Synchronization.....	17

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company	)	
	)	
	)	Docket No. 02-0690
Proposed general increase in	)	
water and sewer rates.	)	

**Direct Testimony of Lafayette K. Morgan, Jr.**

**Introduction and Summary**

1    Q.        WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?

2    A.        My name is Lafayette K. Morgan, Jr. I am a Senior Regulatory Analyst with Exeter  
3               Associates, Inc. Our offices are located at 12510 Prosperity Drive, Silver Spring,  
4               Maryland 20904. Exeter is a firm of consulting economists specializing in issues  
5               pertaining to public utilities.

6    Q.        PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND  
7               QUALIFICATIONS.

8    A.        I received a Masters of Business Administration degree with a concentration in  
9               finance from The George Washington University. I received a Bachelors of Business  
10              Administration degree with a concentration in Accounting from North Carolina Central  
11              University. I am also a Certified Public Accountant, licensed in the State of North  
12              Carolina.

13   Q.        WOULD YOU PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE?

14   A.        A copy of my Curriculum Vitae is attached as Appendix A. A brief summary of my  
15               professional experience to date follows. From May 1984 until June 1990, I was  
16               employed by the North Carolina Utilities Commission (NCUC) - Public Staff in Raleigh,

1 North Carolina. I was responsible for analyzing testimony, exhibits, and other data  
2 presented by parties before the NCUC. Other responsibilities included performing the  
3 examinations of books and records of utilities involved in rate proceedings, and  
4 summarizing the results into testimony and exhibits for presentation before the NCUC. I  
5 was also involved in numerous special projects, including participation in compliance and  
6 prudence audits of a major utility, and conducting research on several issues affecting  
7 natural gas and electric utilities.

8 From June 1990 until July 1993, I was employed by Potomac Electric Power  
9 Company (Pepco) in Washington, D.C. At Pepco, I was involved in the preparation of  
10 the cost of service, rate base, and ratemaking adjustments supporting the company's  
11 requests for revenue increases in the State of Maryland and the District of Columbia. In  
12 addition, I was responsible for preparing Pepco's lead-lag study. I also conducted  
13 research on several issues affecting the electric utility industry for presentation to  
14 management.

15 In July 1993, I accepted my current position with Exeter Associates, Inc. Since then,  
16 I have been involved in the analysis of the operations of public utilities, with particular  
17 emphasis on utility rate regulation. I have also been involved in the review and analysis  
18 of utility rate filings, focusing primarily on revenue requirements determination. This  
19 work has involved natural gas, water, electric, and telephone companies.

20 Q. HAVE YOU PREVIOUSLY TESTIFIED IN REGULATORY PROCEEDINGS ON  
21 UTILITY RATES?

22 A. Yes. I have previously presented testimony and affidavits on numerous occasions  
23 before the NCUC, the Pennsylvania Public Utility Commission, the Virginia Corporation  
24 Commission, the Louisiana Public Service Commission, the Georgia Public Service

1 Commission, the Kentucky Public Service Commission, the Maine Public Utilities  
2 Commission, the Public Utilities Commission of Rhode Island, the Vermont Public  
3 Service Board, the West Virginia Public Service Commission and the Federal Energy  
4 Regulatory Commission (FERC).

5 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

6 A. Exeter Associates has been retained by the Citizens Utility Board (CUB) to review  
7 the reasonableness of the level of revenues which Illinois-American Water Company  
8 (IAWC or the Company) is proposing to charge its customers. In this testimony, I  
9 present my findings regarding certain adjustments to IAWC's test year rate base and net  
10 operating income at present rates. In addition, I also present a summary of findings  
11 regarding the current levels of IAWC's earnings and determine the necessary change in  
12 its revenues which is required to produce an overall rate of return on a rate base of  
13 8.01%, as requested by the Company. Although the attached schedules incorporate the  
14 Company's overall rate of return, CUB has in no way adopted the Company's overall  
15 return. My testimony does not address rate of return at this time, but CUB reserves the  
16 right to adopt a rate of return in subsequent testimony or at another point during the  
17 pendency of this proceeding.

18 Q. IN CONNECTION WITH THIS PRESENT CASE, HAVE YOU PERFORMED AN  
19 EXAMINATION AND REVIEW OF THE COMPANY'S TESTIMONY AND  
20 EXHIBITS?

21 A. Yes. I have reviewed IAWC's testimony and exhibits, its rate filing, as well as its  
22 responses to CUB's and other parties' data requests.

23 Q. WOULD YOU PLEASE SUMMARIZE WHAT IS PRESENTED ON THE  
24 ATTACHED SCHEDULES?

1 A. Yes. I have prepared a set of schedules which present my findings and  
2 recommendations regarding the Company's rate base and cost of service. Schedule  
3 LKM-1 summarizes my overall findings regarding cost of service. Schedule LKM-2  
4 presents a summary of rate base and my adjustments thereto. Schedule LKM-3  
5 summarizes my adjustments to IAWC's net income. The remaining schedules show the  
6 derivation of each of my adjustments to rate base and net operating income.

7 Q. PLEASE SUMMARIZE YOUR FINDINGS.

8 A. As shown on Schedule LKM-1, I have determined that IAWC's overall increase  
9 should be \$15,675,831, which is \$20,580,423 less than the Company's requested revenue  
10 increase of \$36,256,254.

11 Q. WHAT TIME PERIOD DID YOU USE IN YOUR ANALYSIS OF THE  
12 COMPANY'S OPERATING RESULTS?

13 A. My analysis is based upon the Company's operating results on the forecasted test year  
14 ending December 31, 2003. This is the same period used by the Company in its rate  
15 filing, direct testimonies and exhibits.

16 Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

17 A. The remainder of my testimony addresses the individual adjustments I propose, and is  
18 presented in the order identified in the table of contents. For each issue, I document and  
19 explain why the proposed adjustment is necessary.

20  
21 Cash Working Capital

22 Q. WHY HAVE YOU ADJUSTED CASH WORKING CAPITAL?

1 A. IAWC developed its cash working capital allowance by applying a factor of 13.29%  
2 to the working capital base. The working capital base is comprised of Operations and  
3 Maintenance (O&M) expenses less taxes and certain non-cash items.

4 I recommend reducing the working capital base to reflect the adjustments I made to  
5 O&M expenses. Using IAWC's working capital factor, I derived a working capital  
6 allowance of \$9,857,899. This decreases working capital by \$2,534,660. This  
7 adjustment is shown on attached Schedule LKM-4.

8  
9 Reverse Osmosis Expense

10 Q. WHAT ADJUSTMENT HAVE YOU MADE RELATING TO THE REVERSE  
11 OSMOSIS EXPENSES?

12 A. During 2001, the Company rented equipment to reduce high nitrate levels at the  
13 Streator Water Treatment Facility. The equipment used for the reverse osmosis process  
14 was utilized as a temporary solution for reducing the level of nitrate in the water. In this  
15 filing, IAWC has proposed an adjustment to amortize the costs relating to the reverse  
16 osmosis process over a five-year period. As a result, the Company's O&M expenses  
17 increased by \$95,967, and rate base increased by \$431,853 to reflect the unamortized  
18 balance.

19 I recommend removing IAWC's adjustments to rate base and O&M expenses  
20 based upon reverse osmosis expense because these costs are one-time prior period costs  
21 and their inclusion in this proceeding would constitute retroactive ratemaking.

22 Retroactive ratemaking should not be allowed because rates are set prospectively. The  
23 Company has selected a forecasted test year which it believes represents its normal  
24 ongoing level of costs. It is inappropriate to include costs from a prior period because

1 this violates the test year concept. Moreover, once rates are set, those rates are deemed  
2 just and reasonable to recover the utility's costs. If the utility has reason to believe the  
3 costs it is incurring in a current period are not being recovered through its rates and  
4 charges, the utility has the right to petition the Commission for some form of redress. It  
5 is my understanding that IAWC did not petition for, nor does it have prior authorization  
6 from the Commission, to defer and amortize these costs. Thus, there is no basis upon  
7 which to include prior period costs in this proceeding. I have presented this adjustment  
8 on Schedule LKM-5. This adjustment reduces rate base by \$431,853 and O&M expenses  
9 by \$95,967.

10  
11 Amortization of Prior Period Security Costs

12 Q. WHAT ADJUSTMENT HAVE YOU MADE TO THE AMORTIZATION OF  
13 SECURITY COSTS?

14 A. As a result of the September 11th terrorists attack, the Company increased security at  
15 its facilities. In its filing, the Company is proposing to amortize these prior period  
16 security costs over a five-year period and include the unamortized balance in rate base.

17 I recommend reversing the Company's adjustment to rate base and O&M expense  
18 with respect to security costs because these costs represent a prior period. Given that  
19 they are outside of the test year, the inclusion of these costs would constitute retroactive  
20 ratemaking. As explained above, rates are deemed just and reasonable until changed by  
21 the Commission. In any period where the Company does not believe its rates are  
22 adequate, the Company has the right to petition the Commission for relief. In this  
23 instance it has not requested nor has the Commission authorized a deferral and recovery



1 of these prior period costs. Schedule LKM-6, reflects the recommended adjustment  
2 which decreases O&M expenses by \$2,494,740 and rate base by \$9,828,261.

3 Q. ARE THERE OTHER CONCERNS YOU HAVE REGARDING THE PRIOR  
4 PERIOD SECURITY COSTS?

5 A. Yes. Because the Company has failed to provide detailed supporting data, it is  
6 impossible to determine whether the costs incurred are truly incremental. For example,  
7 these costs may include payroll costs. However, we must examine whether such payroll  
8 costs would have been incurred regardless of the September 11<sup>th</sup> event. CUB requested  
9 supporting data for these security costs. Because of IAWC's failure to provide data in  
10 enough detail to evaluate the various components, I am unable to assess the  
11 reasonableness of the costs. Therefore, it is CUB's position that these costs should be  
12 disallowed due to the lack of support.

13 I note too, that federal grants were also available to offset many of the post-  
14 September 11<sup>th</sup> security costs. \*\*\*

15  
16  
17  
18 \*\*\*

19  
20 Chemicals Expense

21 Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO CHEMICALS EXPENSE.

22 A. I recommend an adjustment to reflect the 2003 chemical prices from IAWC's  
23 suppliers. In the Company's filing, it projected the test year level of chemicals expense  
24 by determining the chemical usage and applying the then current established price per

1 pound.<sup>1</sup> The established price per pound was the result of a competitive bidding process  
2 for the years 2001 and 2002. The resulting cost was then escalated by 2.5% to derive the  
3 2003 level of expenses.

4 During discovery, the Company provided 2003 chemical prices that resulted from  
5 the most recent bidding process. I applied the 2003 prices in conjunction with the  
6 projected 2003 usage to derive the annual chemicals expense. I believe that, when  
7 available, the use of actual prices is a more reasonable basis upon which to establish  
8 rates. Schedule LKM-7, reflects this adjustment which reduces O&M expenses by  
9 \$1,054,274.

10  
11 Fuel and Purchased Power Expense

12 Q. WHY HAVE YOU ADJUSTED FUEL AND PURCHASED POWER EXPENSE?

13 A. In determining the level of fuel and purchased power expense for the projected test  
14 year, the Company determined the annual power consumption and applied power rates  
15 based on applicable rate schedules. IAWC then escalated the resulting purchased power  
16 amount by 2.5% to derive the test year purchased power amount.

17 My adjustment to purchased power expense removes the 2.5% escalation  
18 resulting in a decrease of this line item by \$128,842. The probability of the Company  
19 experiencing a purchased power rate increase is almost naught. IAWC has stated that the  
20 power companies in the areas it serves are not proposing any rate increases at this time.<sup>2</sup>  
21 Therefore, there is no need to escalate purchased power costs. Power purchased under  
22 tariffs is not subject to change under inflationary pressures like other commodities

---

<sup>1</sup> IAWC Exhibit 4.2, p. 6.

<sup>2</sup> Company Response to CUB Data Request 2.07.

1 purchased in the competitive market. Therefore, applying an inflation factor is  
2 inappropriate. This adjustment is reflected on Schedule LKM-8.

3 Q. YOU HAVE INDICATED THAT THE POWER SUPPLIERS ARE NOT  
4 PROPOSING TO INCREASE RATES, BUT ISN'T IT TRUE THAT A CHANGE IN  
5 THE RATE STRUCTURE COULD RESULT IN A CHANGE IN POWER COSTS?

6 A. Yes, however, that is a scenario that is neither known nor certain, therefore it should  
7 not be considered as justification to increase purchased power expenses.  
8

9 Waste Disposal Expenses

10 Q. WHY HAVE YOU MADE AN ADJUSTMENT TO REDUCE WASTE  
11 REMOVAL COSTS?

12 A. IAWC determined the test year waste disposal cost by escalating historical data to  
13 derive the projected amount for the test year. In some instances, the Company used data  
14 from 2001, escalated them by 3.2% to derive the 2002 level, and then escalated the  
15 resulting amounts by 2.5% to derive the 2003 projected test year costs. In other  
16 instances, the Company escalated the amounts included in the 2002 plan (a projection  
17 itself) and escalated them by 2.5 percent to derive the projected test year costs. The  
18 exception to this approach is the projected amount for the Piassa Creek Project, which is  
19 based on a contract amount.

20 I adjusted waste disposal costs to reflect the last known actual costs reported. My  
21 reason for doing so is twofold. First, the cost for waste disposal is the result of a  
22 competitive bidding process. Therefore, it cannot simply be assumed that waste disposal  
23 costs will increase in excess of 5.0%. A true competitive bidding process creates  
24 pressure for bidders to price their services as low as possible. For example, reflection of

1 the actual chemical prices resulted in a reduction in the projected chemical costs  
2 presented by the Company. The change, if any, in the level of waste disposal costs from  
3 the bidding process is unknown.

4 Second, the practice of escalating a previous projection, which was probably derived  
5 from the application of an escalation rate, creates great potential for overcharging  
6 ratepayers. The use of a general escalator is not the best method of predicting cost  
7 because it assumes all prices will increase. This assumption is generally untrue. Thus,  
8 “pancaking” escalations creates a potential for a distortion in the costs. Based upon  
9 IAWC’s filing date, actual amounts for part of 2002 should have been available to  
10 provide a more reasonable base from which to project the future test year amounts.  
11 Hence, the basis of the projected test year amount is unreasonable.

12 Based on the foregoing, I propose an adjustment to reduce waste disposal costs by  
13 \$60,477 as illustrated in Schedule LKM-9.

14  
15 Management Fees

16 Q. WHY HAVE YOU REMOVED MANAGEMENT FEES?

17 A. Included in IAWC’s cost of service is approximately \$4.5 million (excluding  
18 Customer Call Center charges) for management fees from American Water Works  
19 Service Company (Service Company). During discovery, CUB requested a breakdown  
20 of the components of the management fees in order to allow me to make an assessment of  
21 the reasonableness of the Service Company’s charges. However, the data supplied by  
22 IAWC was summarized at the cost center level and did not provide sufficient detail for  
23 me to make such an assessment.<sup>3</sup> As a result, management fees for the cost of service

---

<sup>3</sup> Company Response to CUB Data Request 2.10.

1 should be removed because IAWC has not substantiated this amount. If the Company  
2 provides the necessary data, I will review them and make any necessary changes to my  
3 adjustment. Schedule LKM-10, reflects my recommended removal of \$4,480,355 in  
4 management fees.

5  
6 Customer Call Center Expense

7 Q. WHY HAVE YOU REMOVED CUSTOMER CALL CENTER COSTS FROM  
8 EXPENSES?

9 A. IAWC included \$2,438,477 in the cost of service for the Customer Call Center  
10 charges. As with the management fees, CUB requested data that would show the  
11 derivation of the charges in order to allow me to assess whether the test year amount was  
12 reasonable. However, IAWC supplied only the total amount, which did not provide  
13 sufficient detail for me to make such an assessment.<sup>4</sup> As a result, I am proposing an  
14 adjustment to remove the Customer Call Center charges because the amount was not  
15 supported. If the Company provides the necessary data, I will review them and make any  
16 necessary adjustment. This adjustment which reduces O&M expenses by \$2,438,477 is  
17 presented on Schedule LKM11.

18  
19 Group Insurance

20 Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO GROUP INSURANCE  
21 EXPENSES.

22 A. The Company has projected the level of group insurance costs by applying a 13.5%  
23 increase to medical and dental insurance, life insurance and long-term disability costs. In

---

<sup>4</sup> Company Response to CUB Data Request 2.13

1 determining the net cost to the Company, IAWC also subtracts employee contributions  
2 and insurance reimbursements and adds costs pursuant to the Consolidated Omnibus  
3 Budget Reconciliation Act (COBRA).

4 My proposed adjustments are twofold. First, I removed the 13.5% escalation factor.  
5 This number appears to have been randomly selected. The Company has provided no  
6 data or underlying support for its use of this particular factor. Indeed, CUB requested  
7 support for this factor during discovery, but IAWC failed to provide a basis for utilizing  
8 this number.<sup>5</sup> As stated earlier, if the Company provides the necessary information, I will  
9 review it make the necessary changes to my adjustment.

10 The second component of my adjustment removes the COBRA costs that were  
11 included in the cost of service. Generally, COBRA costs are borne by the former  
12 employee and not the employer. Therefore, it should not be included as a cost  
13 component borne by the Company. As a result it was necessary to remove those costs.

14 Schedule LKM-12, reflects this adjustment which then reduces O&M expenses by  
15 \$455,914.

16  
17 Insurance Other Than Group

18 Q. WHAT ADJUSTMENT ARE YOU PROPOSING TO INSURANCE OTHER  
19 THAN GROUP?

20 A. The Company has proposed to include, in the cost of service, retroactive insurance  
21 adjustments related to casualty insurance for policy years 1998-1999, 1999-2000 and  
22 2000-2001. According to the Company the need for the retroactive adjustment is the  
23 result of its experience with high insurance losses. The losses are related to workers

---

<sup>5</sup> Company Response to CUB Data Request 2.14.

1 compensation issues, water main breaks and unfavorable court rulings. The Company  
2 proposes to include \$429,684 in expenses to retroactively recover past losses.

3 Q. CAN YOU EXPLAIN HOW THIS INSURANCE WORKS?

4 A. Yes. Essentially the Company participates in a prepaid insurance program, which  
5 involves the prepayment of funds to the insurance company. The purpose of this  
6 insurance is to provide funds in a given current period to maintain a cash reserve level  
7 that is adequate to meet future claims arising from that period. Funds held by the  
8 administrator are used to pay claims as they arise. If claims exceed what was forecast,  
9 the cash reserve may fall below what is determined to be adequate. If claims are less than  
10 forecast, the cash reserve will have more adequate reserves. In this proceeding the  
11 Company has determined that the cash balance is not adequate to meet future losses and  
12 expenses. It has also determined that the losses in the past periods are the cause.

13 Q. DO YOU BELIEVE THE COMPANY SHOULD RECOVER THESE  
14 RETROACTIVE ADJUSTMENTS?

15 A. No. I do not believe the Company should include the retroactive adjustments in rates  
16 for the following reasons. First, the losses are prior period costs and rates are set  
17 prospectively as I have explained previously. It is apparent that during those prior  
18 periods the Company did not adequately forecast claims. It is inappropriate to set rate  
19 now to recover past costs. Second, the current normal funding of the cash reserve takes  
20 into account claims that could arise from the current period. Therefore, based on current  
21 funding, there should be adequate cash to meet the claims for the current period. Finally,  
22 it is possible that the Company's future claims could be lower than expected which would

1 result in a surplus that reverses the inadequate cash balance. In fact, the Company has  
2 indicated that it is undertaking actions to mitigate its losses.<sup>6</sup>

3 Based on the foregoing, I recommend a reduction of O&M expenses by \$429,684 on  
4 Schedule LKM-13.

5  
6 Customer Expense

7 Q. WHAT ADJUSTMENTS, IF ANY, HAVE YOU MADE TO CUSTOMER  
8 EXPENSES?

9 A. According to IAWC, customer expenses were adjusted to reflect the following: a  
10 recent 8.8% increase in postage expenses; an escalation of the 2002 plan costs at 2.5%,  
11 and a correction of an overstatement of those costs; a reduction in telephone expenses due  
12 to the conversion to a Customer Call Center; and, a revision of lock box processing fees.

13 I propose adjustments to two areas in which the Company provided inadequate  
14 information, thus hindering my ability to assess the reasonableness of IAWC's suggested  
15 rate increase.<sup>7</sup> First, postage includes an additional increase of \$266,881, which was  
16 neither explained nor supported. Second, the adjustment to office supplies is based upon  
17 a 33% factor to reflect the acquisition of Citizens Utility Company of Illinois. However,  
18 the basis of the factor was not provided. Therefore, I have removed these costs from  
19 O&M expenses because they are unsupported. If IAWC provides the necessary  
20 supporting documentation, I will review them and change my adjustment, if necessary.  
21 On Schedule LKM-14, this adjustment is presented resulting in a decrease to O&M  
22 expenses of \$316,835.

23  

---

<sup>6</sup> Company Response to CUB Data Request 2.16.

<sup>7</sup> Company Response to CUB Data Request 2.17.



1 Ongoing Security Costs

2 Q. WHY HAVE YOU REMOVED ONGOING SECURITY COSTS FROM THE  
3 COST OF SERVICE?

4 A. IAWC included \$6.689 million in O&M expenses for ongoing security costs. CUB  
5 requested data which would have shown the components of cost and enabled me to assess  
6 the reasonableness of the costs. However, IAWC did not provide the data.<sup>8</sup> As a result, I  
7 am removing these costs as being unsupported. Consistent with my position on other  
8 adjustments, if provided the necessary data, I will review then and determine whether a  
9 change in my adjustment is warranted. This adjustment is presented on Schedule LKM-  
10 15.

11  
12 Maintenance Expense

13 Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO MAINTENANCE EXPENSE.

14 A. According to IAWC, a review of maintenance expense was conducted in conjunction  
15 with consideration of possible changes in expenses resulting from new investment,  
16 company programs or new regulations. With the exception of certain additional cost  
17 increases, the test year maintenance expense was derived by escalating the expenses for  
18 the 12 months ending May 31, 2001 by 2% to get the projected 2002 level of costs which  
19 was escalated a second time to derive the 2003 projected costs.

20 I adjusted the maintenance expense, which is comprised of two components. The  
21 first component is the removal of certain non-recurring costs, which were added to the  
22 projected level of expenses, based on applying the escalation rate. A summary of the  
23 non-recurring costs added to these expenses is presented below.

---

<sup>8</sup> Company Response to CUB Data Request 2.20.

Concrete for Streator Dam Facility Handrails	\$62,000
Pekin Well Inspection	33,000
Peoria Well Inspection	66,000
State Corporate Office Carpet Replacement	<u>32,000</u>
	<u>\$193,000</u>

This table illustrates the Company's inclusion of non-recurring costs. For example, one would not expect annual carpet replacement, annual concrete delivery for handrails at Streator or annual well inspections at Pekin and Peoria. However, I would agree that well inspections do occur at various sites during the normal course of operations. Accordingly, I assume the base year upon which the projection is based contains a representative level of ongoing or recurring well inspections. Thus, costs to recover well inspection are already reflected in the cost of service.

The second component of the adjustment is the removal of \$100,000 relating to tank inspections and painting. IAWC has separately identified for specific recovery the steel structures that will be inspected and painted. The inclusion of an additional \$100,000 in maintenance expense appears duplicative.

Schedule LKM-16 reflects a combination of both components of the adjustment resulting in a decrease in operating expenses of \$293,000.

#### Payroll Expenses

Q. DO YOU HAVE ANY CONCERNS REGARDING PAYROLL EXPENSES?

A. Yes. The Company has indicated that during 2003, six of its employees will be transferred to the Service Company.<sup>9</sup> These employees were assigned to install and

---

<sup>9</sup> Company Response to CUB Data Request 1.16.

1 maintain business computer systems, and 100% of their time was previously dedicated to  
2 IAWC activities. The transfer of these employees will reduce IAWC's payroll by  
3 \$613,815. However, the Company claims that no savings will result. This appears  
4 unreasonable given that the Company has already included projected 2003 management  
5 fees in the cost of service. These management fees include charges from the Service  
6 Company, and presumably include charges for all services that will be received.

7 Q. ARE YOU PROPOSING AN ADJUSTMENT TO REFLECT THE DECREASE IN  
8 PAYROLL COSTS OF \$613,815?

9 A. No, not at this time. IAWC provided the response to a follow-up data request  
10 regarding these expenses on February 4, 2003. Therefore, there was insufficient time to  
11 incorporate this adjustment in CUB's recommended revenue requirement. Thus, CUB  
12 reserves the right to propose this adjustment during the rebuttal stage of this proceeding.

13  
14 Interest Synchronization

15 Q. PLEASE EXPLAIN YOUR INTEREST SYNCHRONIZATION ADJUSTMENT.

16 A. To determine the tax-deductible interest for ratemaking, I have multiplied IAWC's  
17 recommended rate base by the weighted cost of debt included in the capital structure.  
18 This procedure synchronizes the interest deduction for tax purposes with the interest  
19 component of the return on rate base to be recovered from ratepayers. As shown on  
20 Schedule LKM- 17, this adjustment decreases the interest deduction by \$388,961 as  
21 compared to the interest deduction recognized by the Company. This increases state and  
22 federal income taxes by \$15,438 and \$130,733, respectively.

23 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

24 A. Yes, it does.

**STATE OF ILLINOIS  
ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company	)	
	)	
	)	Docket No. 02-0690
Proposed general increase in	)	
water and sewer rates.	)	

SCHEDULES ACCOMPANYING THE

DIRECT TESTIMONY OF

LAFAYETTE K. MORGAN, JR.

ON BEHALF OF THE

CITIZENS UTILITY BOARD

FEBRUARY 2003

---